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C O N F I D E N T I A L SECTION 01 OF 02 RIGA 000318

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SUBJECT: PRESSING LATVIA ON ITS FINANCIAL SITUATION

REF: A) RIGA 314 B) RIGA 290 C) RIGA 238 D) RIGA 182

Classified By: Charge d'affaires Bruce D Rogers. Reason: 1.4 (d)

¶1. (C/NF) The Latvian government continues to struggle with making the necessary structural reforms to implement the terms of it's IMF/EC assistance package. Failure to do so could have serious consequences not only for Latvia, but for a number of other states in the region. The U.S. has a strategic interest in avoiding this scenario with regard to Latvia as well as avoiding the spillover to other countries. Latvian efforts to date have been hampered by weak political leadership, a culture of corruption, and a lack of human capacity. It seems that the results of the June 6 elections will not effect the process in the short term, but they certainly won't make the medium-term strategy any easier. From our perspective, it seems that the EU is unwilling to take a tough line with the Latvians and the IMF fears being seen as "the bad guys," which contribute to the problem. We believe that strong messages are needed to Latvia's leaders, as well as key EU and IMF officials, to stress the U.S. commitment to Latvia, but to express concern that the process is getting off track and needs quickly to be righted.

¶2. (C/NF) The Latvian government's current proposal is to adopt amendments to the budget in final form by June 17. Leaders agreed on June 8 to cut 500 million lats (roughly a billion dollars) from the planned 2009 budget, or about 10 percent of the budget, in that nine day period. Since December, Latvian officials have been telling us that they are making painful cuts and slashing salaries and personnel. Our experience is that personnel reductions to date have been slim and salary cuts have been largely implemented through compulsory, unpaid leave and reductions in allowances and bonuses. The state auditor, a respected non-partisan figure, reports that she has yet to see the government take a strategic approach to considering what functions government should undertake and what resources should be allocated to them. The IMF team on the ground similarly reports that Latvian proposals to date have lacked credibility. Latvia's political system, which is based more on personalities than on policy and in which parties largely exist to line the pockets of powerful patrons, directly contributes to the problem. Reform of the system is a long-term project that needs more attention - and outside resources - in parallel to the structural reforms. Finally, the politicization of government hiring in recent years means that the crop of Latvian bureaucrats able to act impartially in proposing changes to the governmental structure and budget are limited. Additional outside technical assistance may be needed.

¶3. (C/NF) In Latvia, we recommend that Washington instruct the Charge to demarche the Prime Minister, Speaker, Justice Minister (as head of the People's Party) and President along the following lines:

-- The United States is concerned about the relatively slow pace of implementation of the structural reforms required by the agreements with the IMF, European Commission and others.

Since December, many plans have been announced but few implemented. We are long-standing friends and Allies, and we present these impressions out of desire to help with an outside perspective.

-- The goal of the program remains to meet the Maastricht criteria to allow Latvia to join the Euro-zone. We support that.

-- We welcome the June 8 agreements between the government and social partners to cut an additional 500 million lats from this year's budget.

-- But a strategic view of the role of government and the relative priority of various activities is needed, not simply mandating percentage cuts in various sectors. We know it is hard to declare any government program or position "expendable," but without making the hard choices, we do not see any way to reach the ultimate goal.

-- And while we understand that spending this year may need to be higher than planned to maintain social order, the program must be seen as a multi-year effort to get to a 3% deficit.

-- Financial markets have noticed the reluctance to make hard decisions and are beginning to react. Some of the quotes about devaluation being inevitable may overstate the situation, but it is clear that if Latvia does not demonstrate the will to create significant wage deflation, the external pressure to devalue will only continue to build.

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-- Observers are also looking for evidence that political parties are themselves serious about reform and reductions, and not simply about taking care of their supporters or patrons.

-- Latvia does not have a lot of time. Opinions are crystallizing and markets reacting. These decisions cannot be placed to the side, while parties decide how to realign following Saturday's elections. It is essential that the government and Saeima adopt a strong, credible plan before going on summer recess.

-- Further work will be needed in future. More painful choices will be necessary. But if Latvia takes the tough steps, the United States will support you in your efforts.

14. (C/NF) While it is beyond our area of responsibility, we would encourage that consideration be given to a strong message to the European Commission and the IMF to urge them to be far more direct in their dealings with Latvian officials. Additionally, we are concerned by reports both from the IMF team here as well as rumors within the government that the IMF and Commission representatives on the ground are not fully coordinated in their efforts. We cannot have a situation in which the two work at cross-purposes or with different definitions of success.

15. (C/NF) We can expect real pushback from the Latvians. They will say we don't understand their situation, suggest we are playing into Russian hands, and threaten major cuts in defense spending. But we need to stay firm in our resolve.
ROGERS